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Rules of Origin in Free Trade Agreements

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Introduction

Ascertaining the country of origin of imported products is necessary to be able to apply basic trade policy measures such as tariffs, quantitative restrictions, anti-dumping and countervailing duties and safeguard measures as well as for requirements relating to origin marking, public procurement and for statistical purposes. Such objectives are met through application of basic or non-preferential rules of origin. Countries which offer zero or reduced duty access to imports from certain trade partners will often apply another and different set of preferential rules of origin to determine the eligibility of products to receive preferential access. The justification for preferential rules of origin is to prevent trade deflection, or simple transhipment, whereby products from non-participating countries are redirected through a free trade partner to avoid the payment of customs duties. Hence the role of preferential rules of origin is to ensure that only goods originating in participating countries enjoy preferences.

However, rules of origin can be manipulated to achieve other objectives, such as protecting domestic producers of intermediate goods. Restrictive rules of origin raise the costs of supplying the markets of preferential partners by requiring changes in production which lead to the use of higher cost inputs and through the expenses which are incurred in proving conformity with the rules. These costs entail that only a proportion of products which are eligible for preferential treatment will actually be granted preferential access and will constrain market access relative to what is promised on paper in the trade agreement. *The rules of origin are therefore a key element determining the magnitude of the economic benefits that accrue from preferential trade agreements and who gets them.*

This note reviews the key features of preferential rules of origin and their economic impact. The paper briefly discusses the specification of the rules and the costs incurred by firms to satisfy, and prove conformity to, these rules. These costs act to reduce the value of the tariff preferences that are made available through free trade and preferential trade arrangements.

The Definition of Rules of Origin

When a product is produced in a single stage or is wholly obtained in the partner then the origin of the product is relatively easy to establish. Proof that the product was produced in the preferential trade partner is normally sufficient. For all other cases the rules of origin define the methods by which it can be ascertained that the particular product has undergone *sufficient* working or processing or has been subject to a *substantial* transformation in the partner and that it has not simply been transhipped from a non-qualifying country or been subject to only minimal processing. In practice the higher the level of working that is required by the rules of origin the more difficult it is to satisfy those rules and the more restrictive those rules are in

constraining market access relative to what is required simply to prevent trade deflection.

Unfortunately there is no simple and standard rule of origin which can be identified as performing the role of preventing trade deflection. A number of different rules are available each of which can have different implications for a producer of a given product. Three main methods are used to establish if sufficient processing or substantial transformation has been undertaken: (i) a change of tariff classification[1]; (ii) a minimum amount of domestic value added; or (iii) a specific manufacturing process.

Some agreements, such as the AFTA, apply a single method across all products, however, many trade agreements, most of those implemented by the EU and the US, use all 3 methods, which leads to complex sets of rules of origin. Typically, detailed rules specify which method applies to which product or product group.[2] In the proposed Singapore-US FTA, for example, there are over 240 pages of product specific rules of origin. In certain agreements the rules of origin for a particular product will specify that two or more of the methods must be satisfied, for example, change of tariff heading *and* a certain proportion of domestic value-added. Clearly, satisfying multiple requirements to confer origin is more restrictive. In certain agreements the rules will stipulate alternative methods for particular products, satisfaction of any of which will confer origin. For example, change of tariff heading *or* the specified amount of domestic value-added. Such an approach is more liberal and gives greater flexibility to producers in obtaining origin.

No one method dominates others. Each has its advantages and disadvantages. However, it is clear that different rules of origin can lead to different determinations of origin. Thus, producers who are eligible for preferential access to different markets under different schemes with different rules of origin may find that their product qualifies under some schemes but not others.

There are several other typical features of the rules of origin of preferential trade schemes which can influence whether or not origin is conferred on a product and hence determine the impact of the scheme on trade flows. These are cumulation, tolerance rules and absorption.[3]

Cumulation is an instrument allowing producers to import materials from a specific country or regional group of countries without undermining the origin of the product. The most basic form is bilateral cumulation. In this case originating inputs, that is materials which have been produced in accordance with the relevant rules of origin, imported from the partner qualify as domestic content when used in a country's exports to that partner. Second, there can be *diagonal cumulation* on a regional basis whereby parts and materials from anywhere in the specified region which qualify as originating can be used in the manufacture of a final product which can then be exported with preferences to the partner country market. Finally, there can be *full cumulation* whereby any processing activities carried out in any participating country in a regional group can be counted as qualifying content regardless of whether the processing is sufficient to confer originating status to the materials themselves. Full cumulation provides for deeper integration by allowing for more fragmentation of production processes among the members of the regional group.

Tolerance or De Minimis rules allow a certain percentage of non-originating materials to be used without affecting the origin of the final product. It should be noted that this rule applies to the change of tariff heading and the specific manufacturing rules but does not affect the value added rules. The tolerance rule can act to make it easier for products with non-originating inputs to qualify for preferences.

The *Absorption Principle* provides that parts or materials which have acquired originating status by satisfying the relevant rules of origin for that product can be treated as being of domestic origin in any further processing and transformation. In other words any non-originating materials are no longer taken into account when assessing the nature of further operations.

There are important differences across agreements in the use and nature of these provisions relating to rules of origin, which in turn will affect the impact of the agreement. For example, the EU allows for full cumulation with the ACP countries under the Cotonou Agreement but only provides for bilateral cumulation under the GSP.[4] Under the NAFTA there is a general 7 per cent tolerance level (with exceptions for certain sectors such as textiles and clothing), whilst under the Canada-Chile free trade agreement there is a 9 per cent tolerance level. Thus, there is little commonality across agreements in the precise nature of the rules that are adopted. In general recent agreements involving the EU and the US are based upon detailed, often complex, product-specific rules of origin. The restrictiveness of these rules would appear to vary across sectors. For example, the rules for clothing products can be especially complex (see Box) and particularly difficult to satisfy for small less-developed economies. As such the impact of these agreements will not be uniform across sectors.

The Economic Implications of Rules of Origin

Compliance with rules of origin can affect the sourcing and investment decisions of companies. If the optimal input mix for a firm involves the use of imported inputs which are proscribed by the rules of origin of a free trade agreement in which the country participates then the rules of origin will reduce the value of the available preferences. The firm will have to shift to a higher cost source of inputs in the domestic economy which will reduce the benefits of exporting under a lower tariff. In the extreme, if the cost difference exceeds the size of the tariff preference then the firm will prefer to source internationally and to pay the MFN tariff. The ability to cumulate

Complex and Restrictive Rules of Origin – The Example of Cotton Clothing

EU rules of origin for cotton clothing stipulate that the manufacturing process must 'manufacture from yarn', implying that imported cotton fabric cannot be used and that the yarn must be sourced locally. For many small developing countries this rule is very difficult to satisfy and often precludes the use of preferential access to the EU market under the GSP. In typical US rules of origin a more restrictive effect is achieved by a change of tariff heading rule which precludes the use of imported cotton fabric, imported yarn and imported cotton thread. The rule requires that production of cotton thread, the spinning into yarn, the weaving into fabric and the cutting and making up into clothing must all be undertaken locally. These rules are often further complicated by additional requirements. In US rules of origin, for example, suits, jackets, and coats are also subject to rules relating to the content of the visible lining which must be formed from yarn and finished in the country of export. Thus, imported material for the lining cannot be used.

The restrictiveness of the rules is highlighted in the US case by a series of exemptions to the general rules which appear to reflect very specific interests. For example, in the NAFTA imported fabrics of subheadings 511111 or 511119, use of which would disqualify the clothing product from preferential access under the general rules discussed above, can be used 'if hand-woven, with a loom width of less than 76 cm, woven in the United Kingdom in accordance with the rules and regulations of the Harris Tweed Association, Ltd., and so certified by the Association'.

inputs from a partner under bilateral, diagonal or full cumulation will tend, in increasing order, to open the possibilities for identifying low cost sources of inputs which do not compromise the qualifying nature of the final product. Nevertheless, if the lowest cost supplier is not a member of the area of cumulation then the benefits of the preferential scheme will always be less than indicated by the size of the preferential tariff.

These problems will be exacerbated in sectors where economies of scale are important. A producer which supplies both preferential and non-preferential trade partners, or faces different rules of origin in different preferential partners, will have to produce with a different input mix for different markets if they are to receive preferential access. This may undermine the benefits from lower average costs that would arise if total production were to be based on a single set of material inputs and a single production process.

Rules of origin may be an important factor determining the investment decisions of multinational firms. Such firms often rely on imported inputs from broad international networks which are vital to support the firm specific advantages that they possess, such as a technological advantage in the production of certain inputs. More generally, if the nature and application of a given set of rules of origin introduces a degree of uncertainty concerning the extent to which preferential access will actually be provided this may constrain investment. Restrictive rules of origin discriminate against small countries and LDCs where the possibilities for local sourcing are limited or non-existent.

For companies there is not only the issue of complying with the rules on sufficient processing but also the costs of proving compliance with those rules of origin. The costs of proving origin involve satisfying a number of administrative procedures so as to provide the documentation that is required and the costs of maintaining systems that accurately account for imported inputs from different sources to prove consistency with the rules. The ability to prove origin may well require the use of, what are for small companies in developing and transition economies, sophisticated and expensive accounting procedures.

There is limited information on these costs but the available studies suggest that the costs of providing the appropriate documentation to prove origin can be around 3 per cent of the value of the export shipment for companies in developed countries.[5] The costs of proving origin may be even higher, and possibly prohibitive, in countries where customs mechanisms are poorly developed. Thus, even if producers can satisfy the rules of origin, in terms of meeting the technical requirements, they may not request preferential access because the costs of proving origin are high relative to the duty reduction that is available.

Rules of Origin and the Utilisation of Trade Preferences

Difficulties that may arise in satisfying the rules of origin and the costs of proving conformity with those rules are suggested by the relatively low utilisation rates that are observed in preferential trade schemes. For example, during 1999 under the EU's GSP scheme, only one-third of EU imports from developing countries which were eligible for preferences actually entered the EU market with reduced duties. Under the EU's Everything But Arms Agreement almost all of Cambodia's exports to the EU are eligible for zero duty preferences, yet in 2001 only 36 per cent of those exports obtained duty free access. Brenton (2003) shows that this lack of take-up of preferences entailed that on average Cambodia's exports to the EU paid a tariff equivalent to 7.7 per cent of the value of total exports. The main suspect for this under-utilisation of trade preferences is the rules of origin.

Brenton and Manchin (2002) show that a large amount of EU imports of clothing products from Eastern European countries made from EU produced fabrics still enter the EU market under an alternative customs regime, outward processing, even though there is no fiscal incentive to do so since EU tariffs had been removed under free trade agreements. This probably reflects the costs and uncertainties in proving origin that would be necessary under the normal preferential customs procedures.

Preferential Rules of Origin Increase the Complexity of the World Trading System

Difficulties arise when the same product may have different countries of origin for customs purposes depending upon the market, and the rules of origin, for which it is destined. For example, at present clothing companies in certain African countries can obtain duty free access to the US market under African Growth and Opportunity Act (AGOA) with liberal rules of origin but exactly the same product will be denied duty free access to the EU under the Everything But Arms Agreement (because of the requirement that the product be manufactured from yarn under the EU rules of origin). A company in Singapore could find that its product can enter ASEAN markets duty free, by satisfying the maximum import content requirement of 60 per cent, but does not satisfy the origin rules of the Singapore-Japan agreement. This considerably complicates production and investment decisions.

Complicated systems of rules of origin increase the complexity of customs procedures and the burden upon origin-certifying institutions. This can absorb scarce administrative resources. In a period where increasing emphasis has been placed upon trade facilitation and the improvement of efficiency in customs and other trade-related institutions, the difficulties that preferential rules of origin create for firms and the relevant authorities in developing countries is an important consideration. Hence, less complicated rules of origin stimulate trade between regional partners by reducing the transactions costs of undertaking such trade.

Conclusions

The number of free trade agreements is proliferating. Each of these agreements has a set of preferential rules of origin. The nature of these preferential rules of origin will be a major determinant of the impact of the agreement on trade and investment flows. The following are a general set of recommendations that can be made regarding the specification of these rules:

- Simple, consistent and predictable rules of origin, with minimal costs to firms in adhering to them, are fundamental to effective improvements in market access.
- Rules of origin which vary across products and agreements add considerably to the complexity and costs of participating in and administering trade agreements. The burden of such costs fall particularly heavily upon small and medium-sized firms and upon firms in low-income countries.
- Allowing for widespread cumulation and substantial tolerance margins will tend to offset the restrictiveness of the rules on sufficient processing.
- Restrictive rules of origin targeted at sensitive products are not an effective mechanism for dealing with the adjustment difficulties faced by particular sectors. Longer transition periods to duty elimination (but with a firm commitment to implement) and suitably designed and implemented safeguard measures are more transparent and efficient.
- Complex rules of origin which vary across agreements, by placing greater burdens on customs procedures, may compromise progress on trade facilitation.

[1] This can be applied as a positive determination of origin, whereby the use of inputs from different tariff headings is sufficient to confer origin, or as is common in EU and US agreements as a negative determination of origin. In the latter case the rule will stipulate tariff headings which cannot be used. For example, in the NAFTA, tomato ketchup can be made from imported products of any tariff sub heading except that of tomato paste. In EU agreements biscuits can be made from any imported product except flour.

[2] In EU and US agreements the rules of origin tend to be most restrictive for products of particular interest to developing countries, such as clothing and processed agricultural products (see Estevadeordal and Suominen 2003).

[3] The treatment of duty drawback and of outward processing can also be important. Some agreements contain explicit no-drawback rules which can affect decisions on the sourcing of inputs by firms exporting within the trade area. Increasingly important are rules concerning territoriality and whether processing outside of the area undermines the originating status of the final product exported from one partner to another.

[4] Diagonal cumulation is allowed within four region blocs, SAARC, ASEAN, CACM and ANDEAN, although there is an additional, and often difficult to satisfy, requirement that at least 50 per cent of the value of the product be added in the country of export.

[5] Herin, J (1986). This study also found that the costs for EFTA producers of proving origin led to one quarter of EFTA exports to the EU paying the applied most favoured nation (MFN) duties

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